The Commission proposals for stronger EU economic governance: A comprehensive response to the lessons of the Great Recession

Marco Buti Martin Larch
14 October 2010

The European Commission's proposals for stronger economic governance in the EU have aroused both broad approval and outright condemnation. In this column, the European Commission's Director-General for Economic and Financial Affairs outlines why he and colleagues are confident that the proposals will work.

On 29 September, the European Commission adopted a comprehensive set of proposals to reform and to broaden EU economic governance. The reform package is the most recent step in a much broader effort to incorporate the lessons of the crisis in the EU policy framework, to prevent economic instabilities and, ultimately, to protect workers and taxpayers.

Yet while recent comments have focused on individual sections of the package, in this column we provide an overview of all elements and clarify the thinking behind them.

What are the main goals?

The Commission's legislative package is a blueprint to tackle weaknesses of EU fiscal and macroeconomic surveillance revealed by the Great Recession. Some of these weaknesses were difficult to anticipate, others had been more or less visible. While we all would have preferred avoiding a crisis like the last one, there is an equally broad agreement that this crisis should not be wasted – there are lessons to be learned. It may also be worth noting that public finances did not cause the crisis, yet stronger rules are needed now to put public finances back to a sustainable path.

The Commission's deliberations of 29 September only mark the beginning of a more involved legislative process. Between now and, in all likelihood, the middle of next year, the Council and the European Parliament will, in line with the responsibilities assigned to them by the Treaty, review the Commission's proposals and consider amendments.

Assuming the main thrust of the initial package is preserved, EU governance will undergo important changes. Changes that will make it more effective in important areas of surveillance:

- detecting potentially harmful fiscal and economic developments and
- enforcing the agreed set of rules.

The onset of the crisis has triggered a lively debate in both the academic and policy arena on how to improve EU economic governance. Four distinct areas of discussion have emerged:

- monitoring of fiscal developments,
- the link between macroeconomic imbalances and public finances,
- the enforcement of EU rules, and
- crisis management and resolution.

Reflecting these main areas of discussion, the Commission had already outlined the key directions of its reform plan in May 2010 followed by a more detailed plan at the end of June

(European Commission 2010a, b). The concrete reform package adopted on 29 September comprises six pieces of draft legislation which can be divided into two pillars (European Commission 2010c). The first relates to fiscal governance, the second to broader macroeconomic governance. Within each of the two pillars, proposals can in turn be split into two groups: one having to do with new surveillance tools, both European and national, the second with new tools of enforcement. A schematic representation of the whole package is provided in Figure 1.

Figure 1. Schematic overview of the Commission reform proposals

Fiscal governance	Macroeconomic governance
Surveillance - Preventive arm of the SGP: principles of prudent fiscal policy making (amendment to Regulation (EC) 1466/97) - Corrective arm of SGP: benchmark for sufficiently diminishing debt ratio (amendment to Regulation (EC) 1467/97) - Minimum requirements of national fiscal frameworks (new draft directive)	**Surveillance** New procedures for monitoring, preventing and correcting macrc economic imbalances (new draf regulation)
Enforcement New disincentives/sanctions in case of non-compliance in preventive and corrective arm of SGP (new draft regulation)	**Enforcement** New disincentives/sanctions in case of non-compliance with ne macro surveillance procedure (r draft regulation).

The only element not covered by the Commission's legislative package, but mentioned in the broader reform plan outlined in the Commission communication of 12 May, is the crisis resolution mechanisms. Specific instruments dealing with crisis resolution had already been deliberated in May as a direct response to the mounting sovereign debt crisis.[1]

What is new and why do we need it?

On the surface, each individual element encapsulates a response to weaknesses revealed by the crisis. Starting with fiscal surveillance, the Great Recession indicated, not for the first time, that member states had missed an opportunity to take advantage of the good years preceding the crisis to create fiscal space. Important revenue windfalls were partly used to increase spending just to find out shortly after that expenditure levels were not sustainable.

In order to avoid such unfortunate patterns in the future, the intention under the preventive arm of the Stability and Growth Pact is to use a prudent rate of medium-term economic growth as benchmark for assessing the sustainability of government expenditure growth. Departures from such a benchmark are allowed if they are matched by discretionary revenue measures (rather than by temporary revenue windfalls); uncovered deviations would be in conflict with prudent fiscal policy making.

Prior to the crisis, but especially during the crisis, the dynamics of government debt were increasingly driven by elements other then the deficit. It also became clear that with declining average economic growth it would no longer be sufficient to respect the 3% of GDP reference value to ensure a declining debt ratio. As a result of this, and in a bid to control debt developments, the legislative package proposes a benchmark for sufficiently diminishing debt ratios.

Still under the heading of fiscal surveillance, the package encourages member states to improve domestic fiscal frameworks. The rationale for this proposal is twofold:

- as evidenced by past experience, the enforcement of EU fiscal rules cannot be expected to derive only from EU rules. Domestic budgetary arrangements need to be consistent with the obligations under the pact; and
- there is abundant empirical evidence that fiscal performance tends to improve with the quality of domestic fiscal governance.

The most important extension of EU economic governance implied by the Commission's legislative package relates to the prevention and correction of macroeconomic imbalances. The respective proposal addresses the most serious and particularly bitter lesson of the crisis – a lesson for the economic profession as a whole – namely that fiscal discipline, coupled with low and stable inflation, is not sufficient to guarantee overall macro-financial stability. The new surveillance framework mapped out in the package aims at detecting, as early as possible, macroeconomic imbalances so as to allow a timely formulation of corrective policies.

Finally, the package encompasses a new battery of graduated disincentives and sanctions. While media coverage has mostly, if not exclusively, focused on this aspect it is important to stress that sanctions should not be seen in isolation. They are an integral part of the whole set of proposals in both the fiscal and the macroeconomic pillar and are meant to strengthen the enforcement of the rules. The degree of deterrence of existing sanctions, those under the provisions of the corrective arm of the Stability and Growth Pact, was low because they can kick in only at the very end of the surveillance process.

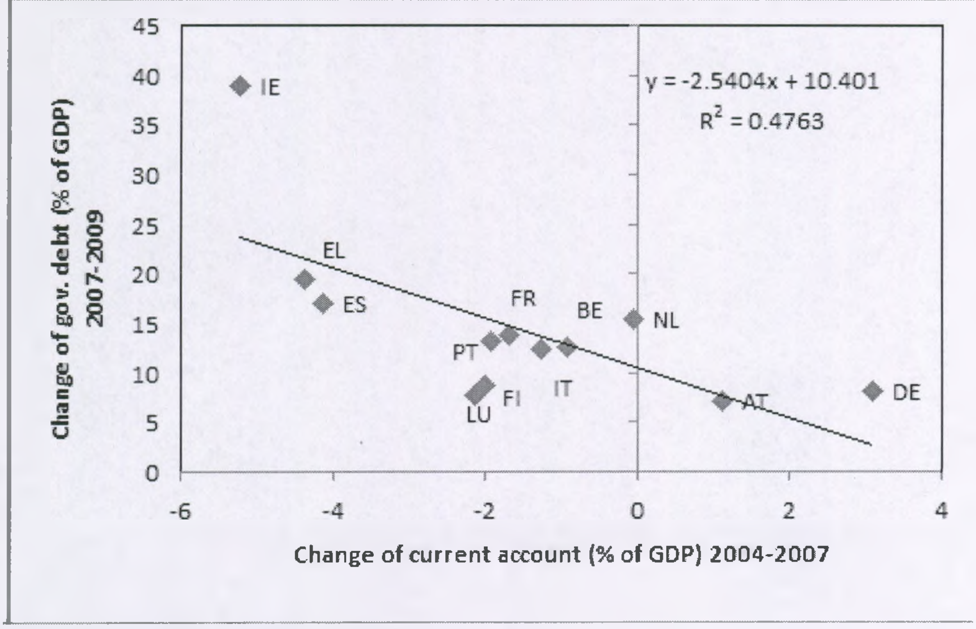
Would the new tools have made a difference?

Once entered into force, it will take a number of years before we will be able to form a solid judgement on the merits of the reformed EU economic governance. This notwithstanding, there are a number of elements that give us sufficient confidence about the effectiveness of the new set of rules, especially when compared with the current Stability and Growth Pact framework.

As regards macroeconomic surveillance, simulations on past data provide encouraging evidence of the potential utility of the proposed instruments. In particular, an alert mechanism based on thresholds for a scoreboard of relevant macroeconomic variables (the current account balance, net foreign assets the real effective exchange rates house prices, the government debt ratio and private sector credit as a percentage of GDP) would have signalled emerging imbalances in Spain and Ireland already in 2004, and even more clearly in 2007.

Figure 2 shows how changes in the external balance ahead of the crisis went along with increases in government debt during the crisis. The exclusive focus on fiscal developments did not capture the mounting risks for public finances, inter alia because revenue windfalls embellished the actual budgetary stance.

Figure 2. External imbalance and government debt

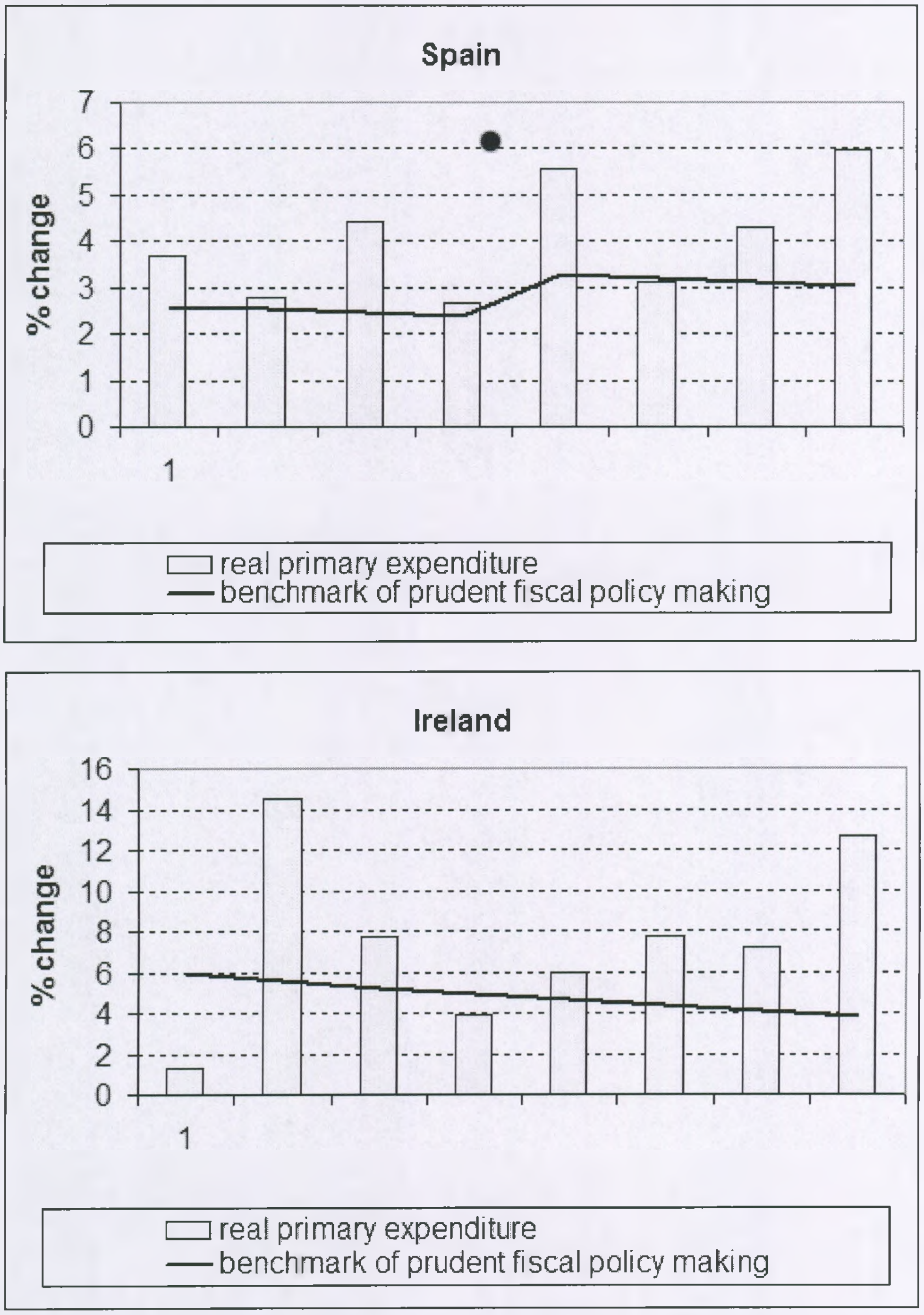


Source: European Commission

In actual practice, the scoreboard-based alert mechanism would not automatically lead to EU policy recommendations. According to the Commission's proposal this would happen only after an in-depth analysis of the country concerned. But the alert mechanism would constitute a first important step in the new surveillance mechanism and seems to give useful and timely signals.

Turning to the concept of prudent fiscal policymaking, the main reform proposal under the preventive arm of the Stability and Growth Pact, a simple exercise on past data also provides some interesting insights. Taking again the two emblematic country cases, Spain and Ireland, Figure 3 sets out the annual rate of growth of real government primary expenditure in 2000-2007 against a benchmark of prudent medium-term economic growth, where the benchmark is defined as the ten-year forward-looking average of the long-term projections (covering a horizon of 50 years) used by the Commission to assess the long-term sustainability of public finances of its member states (details of the projection can be found in European Commission and the Economic Policy Committee 2008).

Figure 3. Expenditure growth vis-à-vis a prudent rate of economic growth



Note: The reference for the benchmark of prudent fiscal-policy making is the 10-year forward-

looking average of the long-term projections of potential output growth used by the European Commission to assess the long-term sustainability of public finances. The benchmark is set equal to this 10-year forward-looking average if a country has already achieved its medium-term objective (MTO). It is set one percentage point below the 10-year forward-looking average if a country has not achieved its MTO yet. Source: European Commission.

The two graphs clearly show that in both countries primary expenditure outpaced a sustainable rate of medium-term economic growth in most years, especially in the 2-3 years preceding the crises, when public coffers benefited from extra revenues linked to a housing and an asset price boom. If the concept of prudent fiscal policymaking had been part of the formal surveillance process, concerns would have been raised earlier and, more importantly, the respective surveillance instruments would have been deployed to correct deviations. Under current provisions no formal steps were possible because both Ireland and Spain had achieved their medium-term budgetary objectives and/or were running a budgetary surplus.

Why only now?

The Great Depression marked a clear break in post-WWII economic history. It brought to a sudden and, for most observers, unexpected close a period which was, with the benefit of hindsight, ironically dubbed the "Great Moderation".

According to the commonly accepted paradigm underpinning the "Great Moderation", keeping the fiscal house in order and inflation low and stable was sufficient to safeguard overall macroeconomic stability. By these standards, most European countries were doing just fine in the years preceding the crisis. In 2007, government deficits in EU member states had reached the lowest levels in more than two decades and inflation was generally low and stable almost everywhere, especially in the euro area.

Admittedly, the 2005 reform of the Stability and Growth Pact, the EU's fiscal governance framework, had revealed some weaknesses, especially in the area of monitoring and enforcement; yet following the 2005 reform, things seemed to be working pretty smoothly.

Then came the crisis. It imposed a sobering assessment of not only macroeconomic prospects. It also called for a fresh look at macro economic policy making as a whole including economic policy coordination in the EU. While there is no doubt that existing EU instruments helped stave off a full-scale depression, the Great Recession has revealed scope for improving and broadening economic governance in the EU. The legislative package of draft reform proposals presented in this contribution is the Commission's response to the gaps and weaknesses in economic and budgetary surveillance exposed by the crisis.

Will it work this time?

Like all real-life reforms, the Commission's proposal can be described as the result of constrained optimisation. First, after the very difficult and, above all, lengthy adoption process of the Lisbon Treaty, the work underpinning the reform proposals took the provisions of EU primary law as given. Second, and linked to the first, although the crisis proved beyond any doubt that more economic policy co-ordination is needed, there is little appetite among member states for more centralisation in the area of fiscal policymaking.

Keeping these constraints in mind, the legislative package represents a fairly encompassing and daring reform of EU economic governance. Moreover, the package is not the only improvement in EU economic governance deliberated in the recent past. Other important steps include:

- the new EU financial supervision framework adopted earlier this year;
- measures to deal with sovereign debt crises agreed by the Council and the Commission in May; and
- a more effective annual calendar for assessing economic policymaking in the EU Member States, the so called "European Semester".

When finally implemented, the actual performance of the new set of rules will also depend on how member states exercise their responsibility under the provisions of the Treaty. At the end of the day, the reform cannot obviate one of the pivotal features of EU economic governance which Peter Sutherland, a former EU Commissioner, succinctly described as the inherent tension between acknowledging the obvious inadequacy of national procedures to confront continental and global challenges while preserving absolute national sovereignty in fiscal, budgetary, and macroeconomic matters.

Nevertheless, in addition to the sound and comprehensive nature of the proposals, what makes us reasonably confident about their effectiveness going forward is that they will interact with an increased degree of attention on the part of financial markets. In fact, the crisis has invited back an older player, which for a long time – as long as the existing rules were backed by results – had taken a back seat. In the aftermath of the crisis there is sufficient awareness that, unless we prefer the merciless judgement of market forces, the credibility vis-à-vis markets can only be re-gained by following agreed rules.

References

European Commission (2010a), "Commission communication of 12 May 2010 on Reinforcing economic policy coordination", 12 May.
European Commission (2010b), "Commission communication of 30 June 2010 on Enhancing economic policy coordination for stability, growth and jobs – Tools for stronger EU economic governance", 30 June.
European Commission (2010c); "A new EU economic governance - a comprehensive Commission package of proposals", 29 September.
European Commission and the Economic Policy Committee (2008), "The 2009 Ageing Report: Underlying Assumptions and Projection Methodologies for the EU-27 Member States (2007-2060)", European Economy, 7 December.

---

[1] On 9/10 May 2010 the ECOFIN Council decided on a comprehensive package of measures. It approved the rescue package for Greece, the European Financial Stability Mechanism, worth up to €60 billion, and the European Financial Stability Facility, worth up to €440 billion.